SUPREME COURT, U. S.

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NO. 1005

IN THE

Supreme Court of the United States

October Term, 1966

REEF CORPORATION, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition For A Writ Of Certiorari To The United States Court of Appeals For The Fifth Circuit

REPLY BRIEF OF PETITIONER

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REPLY BRIEF OF PETITIONER

Just as we state in our reply to the memorandum of the respondent in J. E. Davant, et al. v. Commissioner of Internal Revenue, No. 911, on the present docket of this Court, we submit that a real consideration of the argument of respondent will clearly demonstrate how erroneous are the decisions of the courts below.

In the *Davant* case the respondent refers to only a part of the statement by the Senate Finance Committee in

reference to the reorganization provisions of the 1954 Internal Revenue Code S. Rep. No. 1622, 83rd Cong., 2d Sess., p. 42. In that case we set out the entire part of that report insofar as it deals with these two cases. We quote the following part:

> "The House bill, in the opinion of your committee, contains several important provisions which, by spelling out detailed rules in an attempt to achieve almost mathematical certainty, *would make it difficult for necessary business transactions to be carried out with a minimum degree of interference from the tax laws.*
>
> "The House bill in this area is, in substance, an entirely new statute using few of the terms or concepts with which the courts or the bar have become familiar over the years. Your committee has sought a less extreme approach. Rather than to replace the existing statute, *it has sought to rewrite it so as to preserve the terms and concepts of existing law wherever possible.* It has, however, not hesitated to depart from the present statute *where such departure was necessary in order to remove unwarranted restrictions on necessary or desirable business transactions* or to preclude the use of avoidable devices which have proved successful under the existing code." (Emphasis added)

On the other hand let us see the extremes to which the courts below and respondent have gone to have the tax laws act with a *maximum degree* of interference with a simple ordinary business transaction.

It is true that the present case involves only Reef Corporation and the question of whether its basis for depreciation of the assets bought from Reef Fields is their cost to it or the old lower basis of Reef Fields. The respondent treats the whole transaction as an effort by Reef to get this higher basis by avoiding a reorganization

under sec. 368(a)(1)(D). Actually the effect on Reef was never even considered and this basis point arose entirely separate from the main transaction. We can show this very quickly.

As shown in our petition three men, Butler, Miller and Lents, were oil and gas engineers and put Reef Fields together to build this casinghead gasoline extraction plant. They operated the plant with Lents primarily in charge. Reef Fields had outstanding 40,800 shares. Butler, Miller and Lents and their associates in the Butler group formed Reef with 38,200 shares. Petitioner's Exhibit 47 shows how these three owned the stock in each corporation, the following being copied from Exhibit 47:

	Reef Fields Gasoline Corporation		Reef Corporation	
	Stock Owned	%	Stock Owned	%
J. R. Butler	3,092	7.58	8,040	20.98
M. R. Lents	1,696	4.16	6,740	17.59
Martin G. Miller	996	2.44	6,008	15.68
	5,784	14.18	20,788	54.25

After that Exhibit 47 had been put in evidence, Lents on direct examination by the undersigned Homer L. Bruce explained the whole transaction.

"By Mr. Bruce:

A. The latter part of 1958, Mr. Lents, how did you feel about owning 4.16 per cent interest in the Reef Field Gasoline Corporation and being its manager and devoting substantially all of your time to it?

A. Obviously, I wanted to increase my ownership in the operation that I had put together out there, and I went to my two partners and proposed to them that we try to buy out all the other stockholders that we could.

Q. Now, did you take the matter up with men, like, say, Favrot and Peterkin and some of the other leading ones to determine whether they wanted to sell or what they wanted to do?

A. Yes, sir, we took it up with all the stockholders. Actually, Mr. Butler had the initial discussion with him.

Q. State whether or not it was decided that you would form a new corporation, Reef Corporation.

A. *Yes, we, of course, assumed that we had to form a new company.* I chose the name of Reef Corporation mainly because I wanted a name that smacked of the old name because it would help me to some extent, to have a little continuity where casinghead contracts were concerned.

Q. What was the final price per share that was agreed upon as to the stockholders who were going to sell their stock? I am not trying to break it down into notes or anything but, say, the total aggregate per share.

A. $150 per share." (R. 49-50)

"Q. Now, was the matter ever considered one way or the other as to whether Reef was going to pay $150 per share in cash or what was it going to do? I believe, Mr. Lents, the record already shows or the record will show how many shares were sold, and at $150 per share, this would come up to something over five million dollars.

Could Reef pay that amount in cash?

A. No, sir. We couldn't come up with that much money.

Q. Then state whether or not it was known to all parties that Reef would have to give practically all

of the consideration in the form of notes of some kind.

A. Well, I wouldn't say practically all. Final negotiations wound up with $62.50 a share cash and the balance a note.

Q. In other words, Reef itself did not have the cash to pay this whole five million dollars?

A. That's right.

Q. Now, was it considered how you would handle this transaction, or was there a plan whereby Reef Fields Gasoline Corporation would sell their assets to Reef Corporation for all these notes?

A. That it—

Q. You are familiar with A, B, C, D, E, and F notes Reef gave for all the assets, are you not?

A. Yes, sir.

Q. *Was it considered whether Reef Fields should sell these assets to Reef for these notes and then dissolve the corporation in 1958 and distribute these notes to the stockholders and whatever cash it had?*

A. That is the way we thought of first.

Q. Was that satisfactory to all of you?

A. It was until you told us we would all have to pay a capital gains tax on these notes which we were going to get, we couldn't make the deal that way." (R. 51-52)

"Q. State whether or not you were advised—

A. I was advised.

Q. Wait a minute. State whether or not you were advised that if Reef Fields sold its properties to Reef Corporation for these A to F notes, then Reef Fields dissolved their corporation in 1958 and distributed these notes to the stockholders and whatever cash it had, the stockholders in Reef Fields would thereupon incur a capital gains tax on the whole amount in 1958 on their property?

A. Yes.

Q. State whether or not that was satisfactory to you and the other partners.

A. It was not.

Q. State whether or not you are familiar with the method of making sales of property under the Internal Revenue Code and returning your profit on an installment basis.

A. Yes, sir, I am familiar with that and was at that time, yes.

Q. Now, state whether or not stockholders in coming to the final decision as to the plan and whether you wanted to arrange it so that you would come under the installment reporting basis.

A. Yes, that is the way we wanted to do it so when we received the money we would pay the tax.

Q. Now, state whether or not that matter was discussed with Mr. Favrot and the crowd that sold out in December, 1956.

The Court:
You mean 1958, Mr. Bruce?

Mr. Bruce:
Yes, 1958.

A. Yes, sir. It was discussed with them.

Q. I believe the record shows that Mr. Favrot and some of them all sold out in 1958, is that correct?

A. Yes, sir, some of them did make their sale at that time." (R. 53-54)

"Q. Mr. Lents, state whether or not some of the stockholders sold their stock in December, 1958 to Mr. George Strong, Trustee.

A. Yes, sir, several of them.

Mr. Friedman:
Again, we object to the word 'sold' in reference to these transactions. This is a legal conclusion.

The Court:
He is using the word as used in common parlance, that they handed it over and got some money.

Mr. Bruce:

I would like to have that understanding, that we are using the word 'sold', not in the technical manner, but in the usual sense.

The Court:

We very often have a question where there is no question somebody handed something over and got money for it and the whole issue—

Mr. Friedman:

With that understanding and agreement with Mr. Bruce, I will make no further objection of this type." (R. 55-56)

"Q. Mr. Lents, I will not go through the details of how this transaction was handled through George Strong, Trustee. I want to take that up with another witness who is more familiar with the details. But state whether or not at that time you understood how the various parties and some in December and some in January, were selling their stock to George Strong, Trustee, and then Reef Fields was going to be dissolved. Were you familiar with that?

A. Yes, sir.

Q. Were you familiar with the general set-up?

A. Yes, sir.

Q. *State whether or not you decided to go through that transaction rather than having simply Reef Fields sell the properties for these notes and dissolve and distribute these notes to you.*

A. Yes, sir." (R. 56-57)

We will not restate our views as to why the sale to George Strong, Trustee, should be sustained. We refer to our discussion of that point in our petition for writ of certiorari. However, we refer briefly to respondent's statement on page 5 of his memorandum:

"At most the Trust held title to the Old Reef stock for only a short period while the preconceived plan was carried out."

In *Commissioner v. Brown*, 380 U.S. 563, this Court sustained the transaction where there was a sale to an exempt foundation and it immediately transferred the properties to a corporation

> "while the preconceived plan was carried out."

How can those presently representing the respondent make the statement on page 4 of their memorandum,

> "In general, if substantially all the assets of a corporation (here Old Reef) are transferred to a new corporation (here New Reef) which is controlled by the transferor corporation or one or more of its stockholders, the transaction constitutes a "D" reorganization. 1954 Code §§368(a)(1)(D), 354(b)."

That statement certainly is a condensed statement of all the intricate requirements set out by Congress in sections 368(a)(1)(D) and 354(b) before there can be a (D) reorganization, and it is clear to us that the facts in this case show that there was no (D) reorganization. We have discussed in detail in our reply brief in *J. E. Davant, et al. v. Commissioner*, No. 911 on the docket of this Court how some of the courts have tried to get around the express provisions of (D) by saying that it would be a meaningless gesture for additional stock to be issued in the *Davant* case and in this case and we refer the court to our discussion in the *Davant* case.

As to the holding of the court below that there was a 368(a)(1)(F) reorganization, how could under the facts of this case it be held that the new corporation Reef was

> "a mere change of identity, form, or place of organization, however effected"?

Right in that connection and with the statement on page 8 of respondent's memorandum in reference to the notes that

> "we note that all the notes were held by the stockholders of New Reef in proportion to their stock investments;"

this statement has absolutely no support in the record. We will not give the figures concerning all the stockholders of Reef but will give the figures concerning Butler, Miller and Lents and one of the larger stockholders, Saunders. Of the total of 38,320 shares of Reef and its notes of $4,903,000 these four men owned the following shares and notes:

	Shares	Per Cent of Shares	Notes	Per Cent of Notes
Butler	8,040	20.98	$ 343,200	7.00
Miller	6,008	15.68	59,280	1.21
Lents	6,740	17.59	153,300	3.13
Saunders	6,768	17.66	720,330	14.69
	27,556	71.91	$1,276,110	26.03

How can the respondent still contend that the notes issued by Reef in the purchase of the assets of Reef Fields that are held by the Butler group are to be treated as stock? He does this both to say there was stock distributed by Reef and to deny Reef the deduction for the interest paid on those notes. Incidentally the Government allowed Reef to deduct the interest on the notes that were held by the Favrot group. How can notes of exactly the same series be stock in the hands of the Butler group and notes in the hands of the Favrot group?

Respondent still says they are notes because they come behind a first mortgage held by the insurance company

and because the lower courts estimated they would not begin to be paid off until after seven years or along in 1965. As shown on pages 24 to 25 of our petition, $2,378,000 of the notes had already been paid off on the trial of the case in April, 1964.

Lastly, we wish to point out the extreme quandary in which the respondent's counsel and the Commissioner find themselves as to whether this was a reorganization under (F) or (D). Reef Fields made its tax returns on a fiscal year basis ending June 30 of each year. It sold its properties to Reef on February 28, 1959 and was formally dissolved on April 27, 1959. On the other hand Reef was incorporated on December 15, 1958 and adopted the June 30 fiscal year. Reef Fields, therefore, filed its last return for the period from July 1, 1958, to April 27, 1959, while Reef filed its first return for the period from December 15, 1958 to June 30, 1959. On the same day, December 21, 1962, the Commissioner of Internal Revenue addressed a deficiency letter to Reef covering the period from December 15, 1958, to June 30, 1959, and a deficiency letter designated "Reef Corporation (Successor in name to Reef Fields Gasoline Corporation)" covering the taxable year from July 1, 1958 to June 30, 1959. Copies of those letters are set forth on pages 89 to 98 of our petition. Reef Corporation filed two petitions with the Tax Court. The one on its docket No. 788-63 involved the one addressed to it for the period from December 15, 1958 to June 30, 1959 (R. 152-166). The one on its docket No. 789-63 involved the one covering the fiscal year from July 1, 1958 to June 30, 1959 (R. 170-188). Section 6212 of the Code provides for such deficiency letters but section 6212(c) provides that, after such a notice of deficiency is mailed, the Commis-

sioner has no right to determine any additional tax for the same year if the taxpayer files a petition within the proper time with the Tax Court. These two sections are as follows:

> "SEC. 6212. NOTICE OF DEFICIENCY
>
> (a) In General—If the Secretary or his delegate determines that there is a deficiency in respect of any tax imposed by subtitles A or B, he is authorized to send notice of such deficiency to the taxpayer by certified mail or registered mail."
>
> "(c) FURTHER DEFICIENCY LETTERS RESTRICTED.—
>
> (1) General Rule—If the Secretary or his delegate has mailed to the taxpayer a notice of deficiency as provided in subsection (a), and the taxpayer files a petition with the Tax Court within the time prescribed in section 6213(a), the Secretary or his delegate shall have no right to determine any additional deficiency of income tax for the same taxable year, of gift tax for the same calendar year, or of estate tax in respect of the taxable estate of the same decedent, except in the case of fraud, and except as provided in section 6214(a) (relating to assertion of greater deficiencies before the Tax Court), in section 6213(b)(1) (relating to mathematical errors), or in section 6861(c) (relating to the making of jeopardy assessments)."

Petitioner pleaded in each case the issuance of the two letters (R. 154 and 173) and that, since it was impossible to tell which was mailed first, both were invalid. The respondent admitted that they were mailed simultaneously (R. 23). The Tax Court held that there was no reorganization under section 368(a)(1)(F) and, therefore, the deficiency letter to the Reef Corporation as successor was

invalid and dismissed case No. 789-63, but held there was a reorganization under (D) and the other notice was valid. The Court of Appeals held there was a reorganization under both (D) and (F) and both notices were valid.

The respondent in footnote 6 on page 13 of his memorandum takes a very peculiar position. He states that the judgment of the Court of Appeals that there was an (F) reorganization validates the deficiency notice in 789-63 covering the full year from July 1, 1958 to June 30, 1959. He then states:

> "Thus the court of appeals should have remanded the portion of the case dealing with the short-period deficiency notice so the Tax Court could dismiss that part of the case. Instead it affirmed as to the short period (petitioner's appeal) and remanded only as to the full year deficiency notice (the Government's appeal) (Pet. 56). Thus, as petitioner points out (Pet. 28-29), there are presently two overlapping deficiency notices outstanding against it. However, there is no substance to petitioner's suggestion that the decision below may subject it to two assessments. The Commissioner will, upon disposition of this petition, join with petitioner in asking the court of appeals to order a remand of the entire case, which will permit the Tax Court to reassume jurisdiction with respect to the deficiency notice covering the short period and dismiss it from the case."

This is a remarkable statement. How does the respondent know that the petitioner will join with the respondent in asking the Court of Appeals to do what he says we will do? To our minds, this is just one more illustration of the confusion that the Commissioner is bringing into the administration of the tax laws and getting away from all

concepts with which the courts and the bar had become familiar when the Senate wrote its version of the 1954 Code.

CONCLUSION

As we point out on pages 19 to 21 of our petition, this whole line of cases, holding that the specific requirements of sec. 368(a)(1)(D) need not be met if the stock of both corporations is owned by the same parties, started with the two-to-one decision by the Third Circuit Court of Appeals in *Commissioner v. Morgan,* 288 F.2d 676, under the 1939 Code, with Judge Hastie strongly dissenting. Later cases have merely followed it blindly. The taxpayers and the members of the bar do not agree with that line of argument. This is shown by cases questioning it in presently pending petitions for certiorari in this Court, *Moffatt v. Commissioner,* 363 F.2d 262, petition No. 804, this Term; *J. E. Davant, et al., v. Commissioner,* 366 F.2d 874, petition No. 911, this Term; *Babcock v. Phillips,* petition No. 1215, this Term.

The fundamental fallacy of the courts below and the respondent is illustrated by the following from the opinion of the Court of Appeals quoted at page 10 by respondent:

> "Distilled to their pure substance, two distinct and unrelated events transpired. First, the holders of 48% of the stock in [Old] Reef had their stockholdings completely redeemed. Second, new Reef was formed and the assets of [Old] Reef were transferred to new Reef. The business enterprise continued without interruption during both the redemption and the change in corporate vehicles.
>
> Much confusion flows from the fact that the corporate reorganization took place simultaneously with the stock redemption. But taking the Code as a

> standard, these two elements were functionally unrelated. [Old] Reef could have completely redeemed the stock of 48% of its shareholders without changing the state of its incorporation. * * *"

This Court has rejected this line of argument many times. *Commissioner v. Brown,* 380 U.S. 563; *Hanover Bank v. Commissioner,* 369 U.S. 672; *Turnbow v. Commissioner,* 368 U.S. 527; *Helvering v. Flaccus Leather Co.,* 513 U.S. 247; *Helvering v. Hammel,* 311 U.S. 504; *Old Colony Railroad Co. v. Commissioner,* 284 U.S. 552.

This case does not affect Reef Corporation alone. The Government is already asserting in the courts below that all these notes received by Butler, Miller, Lents and Saunders and others of the Butler group were dividends subject to the regular individual tax rates. In other words, Saunders, for example, is being treated as having received a dividend in one year equal to the amount of the notes he received. The tax liabilities on some of these men, if the judgments of the lower courts are sustained in this case, will be catastrophic.

Your petitioner respectfully prays that its petition for certiorari be granted.

Respectfully submitted,

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